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SUBJECT: STATE BANK GOVERNOR: LACK OF CREDIT STIFLING PAKISTAN'S  
GROWTH; DISCOUNT RATE TO STAY AT 15 PERCENT

11. (SBU) Summary. On January 31, the State Bank of Pakistan (SBP) released its Monetary Policy Statement which maintained the discount rate at 15 percent for the next six months, causing disappointment to many in the private sector who were hoping for an easing of rates. SBP Governor Salim Raza told DCM on February 9 that tight liquidity due to high interest rates and a reluctance of the banking sector to lend will seriously dampen economic growth. Raza will keep interest rates high, however, until inflation comes down, which is starting to occur in the food and consumer indices, although rent and wage inflation remains unchanged. Raza is proud of the discipline the GOP has shown in meeting its IMF targets, and said they deserved a higher loan amount from the Fund if they continue their good performance. Embassy Legal Advisor gave Raza the revised Terms of Reference for the placement of a Treasury advisor in the Financial Monitoring Unit, and Raza promised to get back to us. End Summary

12. (SBU) In a February 9 meeting with DCM, Economic Counselor and Embassy Legal Advisor, State Bank of Pakistan (SBP) Governor Salim Raza discussed how the global contraction in capital flows was particularly devastating for developing countries. Pakistan's situation of slowing economic growth combined with high inflation left the GOP unable to stimulate growth by government spending. The only option was increased lending by the banking sector, since commercial paper and bond markets do not exist in Pakistan. However, the banks - which are recording higher levels of non-performing assets, particularly in the consumer and textile areas - are investing in government securities and holding more cash rather than giving new loans.

13. (SBU) The SBP has injected \$2 billion in additional liquidity in the past quarter by relaxing the banks' reserve requirements (from nine to five percent); however, this has not shown up in larger amounts of bank loans, he said. The IMF wants the private loans to increase by \$6-7.5 billion, but Raza is doubtful if even half that amount is achievable. (Note: In the past three months, for example, private sector credit increased by only \$590 million, compared to \$2.4 billion for the same period a year previously. End Note.) Commenting that the banking sector has been almost completely privatized, Raza said that the SBP could only use moral suasion to convince them to lend more.

14. (SBU) On January 31, the SBP announced that the discount rate would remain at 15 percent for the next six months, disappointing

many in the private sector who had been squeezed by commercial rates of over 20 percent. (The discount rate was raised from 12 to 13 percent in July, and to 15 percent in November.) Raza said he was comfortable with this decision ("I have no problem keeping interest rates where they are"), and would try to hold the line to keep inflation in check.

¶15. (SBU) The increase in the discount rate has encouraged banks to participate in Treasury bill auctions, and enabled the SBP to shift its government debt burden to the private banks. In the six auctions held since November 13, the GOP has raised over \$6 billion, helping it to meet its December IMF targets of less dependence on the central bank. Raza attributed the success of these auctions to the fact that the SBP no longer sets the interest rate it will accept but lets the market determine it. The down side of this policy is the crowding out of the private sector.

¶16. (SBU) Raza said squeezing out inflation is of paramount importance. Wholesale and consumer price indexes have begun to drop. For example, the sensitive food index, which comprises products important to the poorest stratum of society, has fallen by 5 percent. However, core inflation (rents, wages) remains stubborn, dropping almost imperceptibly in December (from 19.6 to 19.5 percent) because, he noted, inflationary expectations are difficult to eradicate quickly.

¶17. (SBU) Raza expressed satisfaction with the GOP's meeting its IMF targets on incremental borrowing and levels of reserves. He said the next IMF review would be forward looking, concentrating on the strength of the banking system and whether the GOP would be able

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to maintain discipline in the face of coming challenges. He said he was looking forward to a constructive discussion with the IMF on how not to "slow down the whole system" due to high interest rates. "If we can keep up discipline, we should ask for [the terms given to] Turkey or Hungary," referring to the larger loan amounts they received from the Fund in their structural readjustment programs.

¶18. (SBU) SBP Policy Statement: In its Monetary Policy Statement for the third quarter of FY09, in which the discount rate was maintained, the SBP estimated lower GDP growth due to energy shortages, lower demand for exports, less available consumer finance and pending circular debt issues. The SDP believes the balance of payments position is still vulnerable due to a slow down in global demand. First half statistics showed that large scale manufacturing remained negative (down 5.6 percent), affected by lower demand, less consumer financing and energy shortages. The external current account deficit remained high, at \$7.3 billion, as lower oil prices had not yet been factored in. The average oil price in the first half was \$109, but benefits will show up later in the fiscal year when import contracts are renegotiated.

¶19. (SBU) Comment: An articulate, polished man with over thirty years of banking experience - many of them with Citibank's London office - Raza projects the self-assurance of a political insider. The concern remains, however, that his close ties with Financial Advisor Shaukat Tarin, also a former Citibank executive, will put at risk the independence from the Finance Ministry that the central bank fiercely maintained under former Governor Shamshad Akhtar, a technocrat from the Asian Development Bank. Indeed, Raza's decision to end SBP involvement in setting interest rates for Treasury bill auctions marks a central bank capitulation in one of the battles that had characterized the fractious SBP-Finance relationship during former Governor Akhtar's tenure.

PATTERSON